JOINT EXPLANATORY STATEMENT OF THE COMMITTEE OF CONFERENCE

The managers on the part of the House and the Senate at the conference on the disagreeing votes of the two Houses on the amendment of the Senate to the bill (H.R. 2), to provide for reconciliation pursuant to section 201 of the concurrent resolution on the budget for fiscal year 2004, submit the following joint statement to the House and the Senate in explanation of the effect of the action agreed upon by the managers and recommended in the accompanying conference report:

The Senate amendment struck all of the House bill after the enacting clause and inserted a substitute text.

The House recedes from its disagreement to the amendment of the Senate with an amendment that is a substitute for the House bill and the Senate amendment. The differences between the House bill, the Senate amendment, and the substitute agreed to in conference are noted below, except for clerical corrections, conforming changes made necessary by agreements reached by the conferees, and minor drafting and clarifying changes.

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I. ACCELERATION OF CERTAIN PREVIOUSLY ENACTED TAX REDUCTIONS

A. Accelerate the Increase in the Child Tax Credit (sec. 101 of the House bill, sec. 106 of the Senate amendment, and sec. 24 of the Code)

Present Law

In general

For 2003, an individual may claim a $600 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter (or descendent of either), or eligible foster child.

The child tax credit is scheduled to increase to $1,000, phased-in over several years.

Table 1, below, shows the scheduled increases of the child tax credit as provided under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

Table 1.–Scheduled Increase of the Child Tax Credit

Taxable Year	Credit Amount Per Child
2003-2004	$600
2005-2008	$700
2009	$800
2010[1]	$1,000

[1] The credit reverts to $500 in taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns.[1] The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying

[1] Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of: U.S. citizens or residents living abroad (sec. 911), residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931), and residents of Puerto Rico (sec. 933)).

child is between $75,000 and $87,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $99,000.

The amount of the tax credit and the phase-out ranges are not adjusted annually for inflation.

Refundability

For 2003, the child credit is refundable to the extent of 10 percent of the taxpayer's earned income in excess of $10,500.[2] The percentage is increased to 15 percent for taxable years 2005 and thereafter. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit, if that amount is greater than the refundable credit based on the taxpayer's earned income in excess of $10,500 (for 2003). The refundable portion of the child credit does not constitute income and is not treated as resources for purposes of determining eligibility or the amount or nature of benefits or assistance under any Federal program or any State or local program financed with Federal funds. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing refundable child credits.

Alternative minimum tax liability

The child credit is allowed against the individual's regular income tax and alternative minimum tax. For taxable years beginning after December 31, 2010, the sunset provision of EGTRRA applies to the rules allowing the child credit against the alternative minimum tax.

House Bill

Under the House bill, the amount of the child credit is increased to $1,000 for 2003 through 2005.[3] After 2005, the child credit will revert to the levels provided under present law. For 2003, the increased amount of the child credit will be paid in advance beginning in July, 2003, on the basis of information on each taxpayer's 2002 return filed in 2003. Such payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

The amount of the child credit is increased to $1,000 for 2003 and thereafter. For 2003, the increased amount of the child credit will be paid in advance beginning in July 2003 on the basis of information on each taxpayer's 2002 return filed in 2003. Advance payments will be

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[2] The $10,500 amount is indexed for inflation.

[3] The increase in refundability to 15 percent of the taxpayer's earned income, scheduled for calendar years 2005 and thereafter, is not accelerated under the provision.

made in a similar manner to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket. The increase in the refundable portion of the credit from 10 percent to 15 percent of the taxpayer's earned income in excess of the threshold amount is accelerated to 2003 from 2005.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

Under the conference agreement, the amount of the child credit is increased to $1,000 for 2003 and 2004.[4] After 2004, the child credit will revert to the levels provided under present law. For 2003, the increased amount of the child credit will be paid in advance beginning in July, 2003, on the basis of information on each taxpayer's 2002 return filed in 2003. The IRS is not expected to issue advance payment checks to an individual who did not claim the child credit for 2002. Such payments will be made in a manner similar to the advance payment checks issued by the Treasury in 2001 to reflect the creation of the 10-percent regular income tax rate bracket.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

[4] The increase in refundability to 15 percent of the taxpayer's earned income, scheduled for calendar years 2005 and thereafter, is not accelerated under the provision.

B. Accelerate Marriage Penalty Relief (secs. 102 and 103 of the House bill, secs. 104 and 105 of the Senate amendment and secs. 1 and 63 of the Code)

1. Standard deduction marriage penalty relief

Present Law

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[5] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation.[6] For 2003, the basic standard deduction for married couples filing a joint return is 167 percent of the basic standard deduction for single filers. (Alternatively, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns.) Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

EGTRRA increased the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return.[7] The

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[5] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

[6] For 2003 the basic standard deduction amounts are: (1) $4,750 for unmarried individuals; (2) $7,950 for married individuals filing a joint return; (3) $7,000 for heads of households; and (4) $3,975 for married individuals filing separately.

[7] The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same after the phase-in period.

increase in the standard deduction for married taxpayers filing a joint return is scheduled to be phased-in over five years beginning in 2005 and will be fully phased-in for 2009 and thereafter. Table 2, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

Table 2.–Scheduled Phase-In of Increase of the Basic Standard Deduction for Married Couples Filing Joint Returns

Taxable Year	Standard Deduction for Married Couples Filing Joint Returns as Percentage of Standard Deduction for Unmarried Individual Returns
2005	174
2006	184
2007	187
2008	190
2009 and 2010[1]	200

[1] The basic standard deduction increases are repealed for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

House Bill

The House bill accelerates the increase in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003, 2004, and 2005. For taxable years beginning after 2005, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

The Senate amendment increases in the basic standard deduction amount for joint returns to 195 percent of the basic standard deduction amount for single returns effective for 2003. The Senate amendment also increases in the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2005.

Conference Agreement

The conference agreement increases the basic standard deduction amount for joint returns to twice the basic standard deduction amount for single returns effective for 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

2. Accelerate the expansion of the 15-percent rate bracket for married couples filing joint returns

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[8] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

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[8] Under present law, the rate bracket breakpoint for the 38.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

15-percent regular income tax rate bracket

EGTRRA increased the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for a single individual filing a single return. The increase is phased-in over four years, beginning in 2005. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return is twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2007. Table 3, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

Table 3.–Scheduled Increase in Size of the 15-Percent Rate Bracket for Married Couples Filing Joint Returns

Taxable year	End Point of 15-Percent Rate Bracket for Married Couples Filing Joint Returns as Percentage of End Point of 15-Percent Rate Bracket for Unmarried Individuals
2005	180
2006	187
2007	193
2008 through 2010[1]	200

[1] The increases in the 15-percent rate bracket for married couples filing a joint return are repealed for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

House Bill

The House bill accelerates the increase of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns for taxable years beginning in 2003, 2004, and 2005. For taxable years beginning after 2005, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The House bill provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2006.

Senate Amendment

The Senate amendment increases in the size of the 15-percent regular income tax rate bracket for joint returns to 195 percent of the size of the 15-percent regular income tax rate bracket for single returns effective for 2003. The Senate amendment also increases in the size of the 15-percent regular income tax rate bracket for joint returns to twice the size of the 15-percent regular income tax rate bracket for single returns effective for 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2005.

Conference Agreement

The conference agreement increases of the size of the 15-percent regular income tax rate bracket for joint returns to twice the width of the 15-percent regular income tax rate bracket for single returns for taxable years beginning in 2003 and 2004. For taxable years beginning after 2004, the applicable percentages will revert to those allowed under present law, as described above.

Effective date.–The conference agreement provision is effective for taxable years beginning after December 31, 2002, and before January 1, 2005.

C. Accelerate Reductions in Individual Income Tax Rates (secs. 101, 102 and 103 of the House bill, secs. 101, 102 and 103 of the Senate amendment, and secs. 1, and 55 of the Code)

Present Law

In general

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2003, the regular income tax rate schedules for individuals are shown in Table 4, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

Table 4.–Individual Regular Income Tax Rates for 2003

If taxable income is over:	But not over:	Then regular income tax equals:
	Single Individuals	
$0	$6,000	10% of taxable income
$6,000	$28,400	$600, plus 15% of the amount over $6,000
$28,400	$68,800	$3,960.00, plus 27% of the amount over $28,400
$68,800	$143,500	$14,868.00, plus 30% of the amount over $68,800
$143,500	$311,950	$37,278.00, plus 35% of the amount over $143,500
Over 311,950		$96,235.50, plus 38.6% of the amount over $311,950
	Head of Households	
$0	$10,000	10% of taxable income
$10,000	$38,050	$1,000, plus 15% of the amount over $10,000
$38,050	$98,250	$5,207.50, plus 27% of the amount over $38,050
$98,250	$159,100	$21,461.50, plus 30% of the amount over $98,250
$159,100	$311,950	$39,716.50, plus 35% of the amount over $159,100
Over 311,950		$93,214, plus 38.6% of the amount over $311,950
	Married Individuals Filing Joint Returns	
$0	$12,000	10% of taxable income
$12,000	$47,450	$1,200, plus 15% of the amount over $12,000
$47,450	$114,650	$6,517.50, plus 27% of the amount over $47,450
$114,650	$174,700	$24,661.50, plus 30% of the amount over $114,650
$174,700	$311,950	$42,676.50, plus 35% of the amount over $174,700
Over 311,950		$90,714, plus 38.6% of the amount over $311,950

Ten-percent regular income tax rate

Under present law, the 10-percent rate applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns. Effective beginning in 2008, the $6,000 amount will increase to $7,000 and the $12,000 amount will increase to $14,000.

The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008. The bracket for single individuals and married individuals filing separately is one-half for joint returns (after adjustment of that bracket for inflation).

The 10-percent rate bracket will expire for taxable years beginning after December 31, 2010, under the sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA").

Reduction of other regular income tax rates

Prior to EGTRRA, the regular income tax rates were 15 percent, 28 percent, 31 percent, 36 percent, and 39.6 percent.[9] EGTRRA added the 10-percent regular income tax rate, described above, and retained the 15-percent regular income tax rate. Also, the 15-percent regular income tax bracket was modified to begin at the end of the 10-percent regular income tax bracket. EGTRRA also made other changes to the 15-percent regular income tax bracket.[10]

Also, under EGTRRA, the 28 percent, 31 percent, 36 percent, and 39.6 percent rates are phased down over six years to 25 percent, 28 percent, 33 percent, and 35 percent, effective after June 30, 2001. The taxable income levels for the rates above the 15-percent rate in all taxable years are the same as the taxable income levels that apply under the prior-law rates.

Table 5, below, shows the schedule of regular income tax rate reductions.

Table 5.–Scheduled Regular Income Tax Rate Reductions

Taxable Year	28% rate reduced to:	31% rate reduced to:	36% rate reduced to:	39.6% rate reduced to:
2001[1]-2003	27%	30%	35%	38.6%
2004-2005	26%	29%	34%	37.6%
2006 thru 2010[2]	25%	28%	33%	35.0%

[1] Effective July 1, 2001.

[2] The reduction in the regular income tax rates are repealed for taxable years beginning after December 31, 2010, under the sunset provision of EGTRRA.

Alternative minimum tax

The alternative minimum tax is the amount by which the tentative minimum tax exceeds the regular income tax. An individual's tentative minimum tax is an amount equal to (1) 26

[9] The regular income tax rates will revert to these percentages for taxable years beginning after December 31, 2010, under the sunset of EGTRRA.

[10] See the discussion of the provision regarding marriage penalty relief in the 15-percent regular income tax bracket, above.

percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of a phased-out exemption amount and (2) 28 percent of the remaining AMTI. The maximum tax rates on net capital gain used in computing the tentative minimum tax are the same as under the regular tax. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments. The exemption amounts are: (1) $49,000 ($45,000 in taxable years beginning after 2004) in the case of married individuals filing a joint return and surviving spouses; (2) $35,750 ($33,750 in taxable years beginning after 2004) in the case of other unmarried individuals; (3) $24,500 ($22,500 in taxable years beginning after 2004) in the case of married individuals filing a separate return; and (4) $22,500 in the case of an estate or trust. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. These amounts are not indexed for inflation.

House Bill

Ten-percent regular income tax rate

The House bill accelerates the increase in the taxable income levels for the 10-percent rate bracket now scheduled for 2008 to be effective in 2003, 2004, and 2005. Specifically, for 2003, 2004, and 2005, the proposal increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

For taxable years beginning after December 31, 2005, the taxable income levels for the 10-percent rate bracket will revert to the levels allowed under present law. Therefore, for 2006 and 2007, the levels will revert to $6,000 for unmarried individuals and $12,000 for married individuals filing jointly. In 2008, the taxable income levels for the 10-percent regular income tax rate brackets will be $7,000 for unmarried individuals and $14,000 for married individuals filing jointly. The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.

Reduction of other regular income tax rates

The House bill accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, for 2003 and thereafter, the regular income tax rates in excess of 15 percent under the bill are 25 percent, 28 percent, 33 percent, and 35 percent.

Alternative minimum tax exemption amounts

The House bill increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $64,000, and for unmarried taxpayers to $43,250, for taxable years beginning in 2003, 2004, and 2005.

Effective date

The House bill provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2006.

Senate Amendment

Ten-percent regular income tax rate

The Senate amendment accelerates the scheduled increase in the taxable income levels for the 10-percent rate bracket. Specifically, beginning in 2003, the Senate amendment increases the taxable income level for the 10-percent regular income tax rate brackets for single individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

Reduction of other regular income tax rates

The Senate amendment accelerates the reductions in the regular income tax rates in excess of the 15-percent regular income tax rate that are scheduled for 2004 and 2006. Therefore, for 2003 and thereafter, the regular income tax rates in excess of 15 percent under the bill are 25 percent, 28 percent, 33 percent, and 35 percent.

Alternative minimum tax exemption amounts

The Senate amendment increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $60,500, and for unmarried taxpayers to $41,500, for taxable years beginning in 2003, 2004 and 2005.

Effective date.–The Senate amendment provision is effective for taxable years beginning after December 31, 2002 and before January 1, 2006.

Conference Agreement

Ten-percent regular income tax rate

The conference agreement accelerates the increase in the taxable income levels for the 10-percent rate bracket now scheduled for 2008 to be effective in 2003 and 2004. Specifically, for 2003 and 2004, the conference agreement increases the taxable income level for the 10-percent regular income tax rate brackets for unmarried individuals from $6,000 to $7,000 and for married individuals filing jointly from $12,000 to $14,000. The taxable income levels for the 10-percent regular income tax rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2003.

For taxable years beginning after December 31, 2004, the taxable income levels for the 10-percent rate bracket will revert to the levels allowed under present law. Therefore, for 2005, 2006, and 2007, the levels will revert to $6,000 for unmarried individuals and $12,000 for married individuals filing jointly. In 2008, the taxable income levels for the 10-percent regular income tax rate brackets will be $7,000 for unmarried individuals and $14,000 for married individuals filing jointly. The taxable income levels for the 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2008.

Reduction of other regular income tax rates

The conference agreement follows the House bill and the Senate amendment.

Alternative minimum tax exemption amounts

The conference agreement increases the AMT exemption amount for married taxpayers filing a joint return and surviving spouses to $58,000, and for unmarried taxpayers to $40,250 for taxable years beginning in 2003 and 2004.

Effective date

The conference agreement generally is effective for taxable years beginning after December 31, 2002. The conferees recognize that withholding at statutorily mandated rates (such as pursuant to backup withholding under section 3406) has already occurred. The conferees intend that taxpayers who have been overwithheld as a consequence of this obtain a refund of this overwithholding through the normal process of filing an income tax return, and not through the payor. In addition, the conferees anticipate that the Treasury will provide a brief, reasonable period of transition for payors to implement these changes in these statutorily mandated withholding rates.

II. DEPRECIATION AND EXPENSING PROVISIONS

A. Special Depreciation Allowance for Certain Property (sec. 201 of the House bill and sec. 168 of the Code)

Present Law

In general

A taxpayer is allowed to recover, through annual depreciation deductions, the cost of certain property used in a trade or business or for the production of income. The amount of the depreciation deduction allowed with respect to tangible property for a taxable year is determined under the modified accelerated cost recovery system ("MACRS"). Under MACRS, different types of property generally are assigned applicable recovery periods and depreciation methods. The recovery periods applicable to most tangible personal property (generally tangible property other than residential rental property and nonresidential real property) range from 3 to 25 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight-line method for the taxable year in which the depreciation deduction would be maximized.

Section 280F limits the annual depreciation deductions with respect to passenger automobiles to specified dollar amounts, indexed for inflation.

Section 167(f)(1) provides that capitalized computer software costs, other than computer software to which section 197 applies, are recovered ratably over 36 months.

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment generally may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year (sec. 179). In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business.

Additional first year depreciation deduction

The Job Creation and Worker Assistance Act of 2002[11] ("JCWAA") allows an additional first-year depreciation deduction equal to 30 percent of the adjusted basis of qualified property.[12] The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The additional first-year depreciation deduction is allowed for both regular tax and

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[11] Pub. Law No. 107-147, sec. 101 (2002).

[12] The additional first-year depreciation deduction is subject to the general rules regarding whether an item is deductible under section 162 or subject to capitalization under section 263 or section 263A.

alternative minimum tax purposes for the taxable year in which the property is placed in service.[13] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. In addition, there are no adjustments to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies. A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.

In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be property (1) to which MACRS applies with an applicable recovery period of 20 years or less, (2) water utility property (as defined in section 168(e)(5)), (3) computer software other than computer software covered by section 197, or (4) qualified leasehold improvement property (as defined in section 168(k)(3)).[14] Second, the original use[15] of the property must commence with the taxpayer on or after September 11, 2001.[16] Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service before January 1, 2005. An extension of the placed in service date of one year (i.e., to January 1, 2006) is provided for certain property

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[13] However, the additional first-year depreciation deduction is not allowed for purposes of computing earnings and profits.

[14] A special rule precludes the additional first-year depreciation deduction for any property that is required to be depreciated under the alternative depreciation system of MACRS.

[15] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer.

If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (i.e., each fractional owner is considered the original user of its proportionate share of the property).

[16] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback.

If property is originally placed in service by a lessor (including by operation of section 168(k)(2)(D)(i)), such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. A technical correction may be needed so the statute reflects this intent.

with a recovery period of ten years or longer and certain transportation property.[17] Transportation property is defined as tangible personal property used in the trade or business of transporting persons or property.

The applicable time period for acquired property is (1) after September 10, 2001 and before September 11, 2004, but only if no binding written contract for the acquisition is in effect before September 11, 2001, or (2) pursuant to a binding written contract which was entered into after September 10, 2001, and before September 11, 2004.[18] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after September 10, 2001, and before September 11, 2004. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed in service date, a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before September 11, 2004 ("progress expenditures") is eligible for the additional first-year depreciation.[19]

Property does not qualify for the additional first-year depreciation deduction when the user of such property (or a related party) would not have been eligible for the additional first-year depreciation deduction if the user (or a related party) were treated as the owner.[20] For example, if a taxpayer sells to a related party property that was under construction prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. Similarly, if a taxpayer sells to a related party property that was subject to a binding written contract prior to September 11, 2001, the property does not qualify for the additional first-year depreciation deduction. As a further example, if a taxpayer (the lessee) sells property in a sale-leaseback arrangement, and the property otherwise would not have qualified for the additional first-year depreciation deduction if it were owned by the taxpayer-lessee, then the lessor is not entitled to the additional first-year depreciation deduction.

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[17] In order for property to qualify for the extended placed in service date, the property is required to have a production period exceeding two years or an estimated production period exceeding one year and a cost exceeding $1 million.

[18] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to September 11, 2001.

[19] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

[20] A technical correction may be needed so that the statute reflects this intent.

The limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F) is increased in the first year by $4,600 for automobiles that qualify (and do not elect out of the increased first year deduction). The $4,600 increase is not indexed for inflation.

House Bill

The House bill provides an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property.[21] Qualified property is defined in the same manner as for purposes of the 30-percent additional first-year depreciation deduction provided by the JCWAA except that the applicable time period for acquisition (or self construction) of the property is modified. In addition, property must be placed in service before January 1, 2006 to qualify.[22] Property for which the 50-percent additional first year depreciation deduction is claimed is not eligible for the 30-percent additional first year depreciation deduction.

Under the House bill, in order to qualify the property must be acquired after May 5, 2003 and before January 1, 2006, and no binding written contract for the acquisition is in effect before May 6, 2003.[23] With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property after May 5, 2003. For property eligible for the extended placed in service date (i.e., certain property with a recovery period of ten years or longer and certain transportation property), a special rule limits the amount of costs eligible for the additional first year depreciation. With respect to such property, only progress expenditures properly attributable to the costs incurred before January 1, 2006 shall be eligible for the additional first year depreciation.[24]

The Committee wishes to clarify that the adjusted basis of qualified property acquired by a taxpayer in a like kind exchange or an involuntary conversion is eligible for the additional first year depreciation deduction.

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[21] A taxpayer is permitted to elect out of the 50 percent additional first-year depreciation deduction for any class of property for any taxable year.

[22] An extension of the placed in service date of one year (i.e., January 1, 2007) is provided for certain property with a recovery period of ten years or longer and certain transportation property as defined for purposes of the JCWAA.

[23] Property does not fail to qualify for the additional first-year depreciation merely because a binding written contract to acquire a component of the property is in effect prior to May 6, 2003. However, no additional first-year depreciation is permitted on any such component. No inference is intended as to the proper treatment of components placed in service under the 30% additional first-year depreciation provided by the JCWAA.

[24] For purposes of determining the amount of eligible progress expenditures, it is intended that rules similar to sec. 46(d)(3) as in effect prior to the Tax Reform Act of 1986 shall apply.

The House bill also increases the limitation on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) in the first year by $9,200 (in lieu of the $4,600 provided under the JCWAA) for automobiles that qualify (and do not elect out of the increased first year deduction). The $9,200 increase is not indexed for inflation.

For property eligible for the present law 30-percent additional first year depreciation, the House bill extends the date of the placed in service requirement to property placed in service prior to January 1, 2006 (from January 1, 2005). Thus, property otherwise qualifying for the 30-percent additional first year depreciation deduction will now qualify if placed in service prior to January 1, 2006. The House bill also extends the placed in service date requirement for certain property with a recovery period of ten years or longer and certain transportation property to property placed in service prior to January 1, 2007 (instead of January 1, 2006). In addition, progress expenditures eligible for the 30-percent additional first year depreciation is extended to include costs incurred prior to January 1, 2006 (instead of September 11, 2004).

Effective date.–The House bill applies to property placed in service after May 5, 2003.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill provision with the following modifications. The conference agreement terminates the provision one year earlier than under the House bill provision. Thus, all references to January 1, 2007, and January 1, 2006, are modified to January 1, 2006, and January 1, 2005, respectively. In addition, the conference agreement provides that the increase on the amount of depreciation deductions allowed with respect to certain passenger automobiles (sec. 280F of the Code) in the first year is $7,650 for automobiles that qualify. The $7,650 increase is not indexed for inflation.

Effective date.–The conference agreement applies to taxable years ending after May 5, 2003.

B. Increase Section 179 Expensing (sec. 202 of the House bill, sec. 107 of the Senate amendment, and sec. 179 of the Code)

Present Law

Present law provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct up to $25,000 (for taxable years beginning in 2003 and thereafter) of the cost of qualifying property placed in service for the taxable year (sec. 179).[25] In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000. An election to expense these items generally is made on the taxpayer's original return for the taxable year to which the election relates, and may be revoked only with the consent of the Commissioner.[26] In general, taxpayers may not elect to expense off-the-shelf computer software.[27]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179.

House Bill

The House bill provision provides that the maximum dollar amount that may be deducted under section 179 is increased to $100,000 for property placed in service in taxable years beginning in 2003, 2004, 2005, 2006, and 2007. In addition, the $200,000 amount is increased to $400,000 for property placed in service in taxable years beginning in 2003, 2004, 2005, 2006 and 2007. The dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2008. The provision also includes off-the-shelf computer software placed in service in a taxable year beginning in 2003, 2004, 2005, 2006, or 2007, as qualifying property.

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[25] Additional section 179 incentives are provided with respect to a qualified property used by a business in the New York Liberty Zone (sec. 1400(f)) or an empowerment zone (sec. 1397A).

[26] Section 179(c)(2). A taxpayer may make the election on the original return (whether or not the return is timely), or on an amended return filed by the due date (including extensions) for filing the return for the tax year the property was placed in service. If the taxpayer timely filed an original return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Treas. Reg. sec. 1.179-5.

[27] Section 179(d)(1) requires that property be tangible to be eligible for expensing; in general, computer software is intangible property.

With respect to a taxable year beginning after 2002 and before 2008, the provision permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Senate Amendment

The Senate amendment is the same as the House bill.

Conference Agreement

The conference agreement follows the House bill and the Senate amendment, with modifications. The conference agreement provides that the increase in the dollar limitations, as well as the provision relating to off-the-shelf computer software, apply for property placed in service in taxable years beginning in 2003, 2004, and 2005. The conference agreement provides that the dollar limitations are indexed annually for inflation for taxable years beginning after 2003 and before 2006. With respect to a taxable year beginning after 2002 and before 2006, the conference agreement permits taxpayers to make or revoke expensing elections on amended returns without the consent of the Commissioner.

Effective date.–Same as the House bill and the Senate amendment.

C. Five-Year Carryback of Net Operating Losses (sec. 203 of the House bill and secs. 172 and 56 of the Code)

Present Law

A net operating loss ("NOL") is, generally, the amount by which a taxpayer's allowable deductions exceed the taxpayer's gross income. A carryback of an NOL generally results in the refund of Federal income tax for the carryback year. A carryforward of an NOL reduces Federal income tax for the carryforward year.

In general, an NOL may be carried back two years and carried forward 20 years to offset taxable income in such years.[28] Different rules apply with respect to NOLs arising in certain circumstances. For example, a three-year carryback applies with respect to NOLs (1) arising from casualty or theft losses of individuals, or (2) attributable to Presidentially declared disasters for taxpayers engaged in a farming business or a small business. A five-year carryback period applies to NOLs from a farming loss (regardless of whether the loss was incurred in a Presidentially declared disaster area). Special rules also apply to real estate investment trusts (no carryback), specified liability losses (10-year carryback), and excess interest losses (no carryback to any year preceding a corporate equity reduction transaction).

The alternative minimum tax rules provide that a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income ("AMTI") by more than 90 percent of the AMTI (determined without regard to the NOL deduction).

Section 202 of the Job Creation and Worker Assistance Act of 2002[29] ("JCWAA") provided a temporary extension of the general NOL carryback period to five years (from two years) for NOLs arising in taxable years ending in 2001 and 2002. In addition, the five-year carryback period applies to NOLs from these years that qualify under present law for a three-year carryback period (i.e., NOLs arising from casualty or theft losses of individuals or attributable to certain Presidentially declared disaster areas).

A taxpayer can elect to forgo the five-year carryback period. The election to forgo the five-year carryback period is made in the manner prescribed by the Secretary of the Treasury and must be made by the due date of the return (including extensions) for the year of the loss. The election is irrevocable. If a taxpayer elects to forgo the five-year carryback period, then the losses are subject to the rules that otherwise would apply under section 172 absent the provision.[30]

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[28] Sec. 172.

[29] Pub. Law No. 107-147.

[30] Because JCWAA was enacted after some taxpayers had filed tax returns for years affected by the provision, a technical correction is needed to provide for a period of time in which prior decisions regarding the NOL carryback may be reviewed. Similarly, a technical correction is needed to modify the carryback adjustment procedures of sec. 6411 for NOLs

JCWAA also provided that an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2001 and 2002, as well as NOL carryforwards to these taxable years, may offset 100 percent of a taxpayer's AMTI.[31]

House Bill

The provision extends the provisions of the five-year carryback of NOLs enacted in JCWAA to NOLs arising in taxable years ending in 2003, 2004, and 2005.[32]

The provision also allows an NOL deduction attributable to NOL carrybacks arising in taxable years ending in 2003, 2004, and 2005, as well as NOL carryforwards to these taxable years, to offset 100 percent of a taxpayer's AMTI.

Effective date.–The five-year carryback provision is effective for net operating losses generated in taxable years ending in 2003, 2004 and 2005. The provision relating to AMTI is effective for NOL carrybacks arising in, and NOL carryforwards to, taxable years ending in 2003, 2004 and 2005.

Senate Amendment

No provision.

Conference Agreement

The conference agreement does not include the House bill provision.

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arising in 2001 and 2002. These issues were addressed in a letter dated April 15, 2002, sent by the Chairmen and Ranking Members of the House Ways and Means Committee and Senate Finance Committee, as well as in guidance issued by the IRS pursuant to the Congressional letter (Rev. Proc. 2002-40, 2002-23 I.R.B. 1096, June 10, 2002).

[31] Section 172(b)(2) should be appropriately applied in computing AMTI to take proper account of the order that the NOL carryovers and carrybacks are used as a result of this provision. *See* section 56(d)(1)(B)(ii).

[32] Because certain taxpayers may have already filed tax returns (or be in the process of filing tax returns) for taxable years ending in 2003, the proposal contains special rules to provide until November 1, 2003 in which prior decisions regarding the NOL carryback may be reviewed by taxpayers.

III. CAPITAL GAINS AND DIVIDENDS PROVISIONS

A. Reduce Individual Capital Gains Rates (sec. 301 of the House Bill and sec. 1(h) of the Code)

Present Law

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Any net capital gain of an individual is taxed at maximum rates lower than the rates applicable to ordinary income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income in each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances that would have been available under the straight-line method of depreciation.

The maximum rate of tax on the adjusted net capital gain of an individual is 20 percent. In addition, any adjusted net capital gain which otherwise would be taxed at a 15-percent rate is taxed at a 10-percent rate. These rates apply for purposes of both the regular tax and the alternative minimum tax.

The "adjusted net capital gain" of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under section 163(d).

The term "28-percent rate gain" means the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in section 408(m) without regard to paragraph (3) thereof), an amount of gain equal to the amount of gain excluded from gross income under section 1202 (relating to certain small business stock),[33] the net short-

[33] This results in a maximum effective regular tax rate on qualified gain from small business stock of 14 percent.

term capital loss for the taxable year, and any long-term capital loss carryover to the taxable year.

"Unrecaptured section 1250 gain" means any long-term capital gain from the sale or exchange of section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which section 1231 applies shall not exceed the net section 1231 gain for the year.

The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and the 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured section 1250 gain or 28-percent rate gain otherwise taxed at a 15-percent rate is taxed at the 15-percent rate.

Any gain from the sale or exchange of property held more than five years that would otherwise be taxed at the 10-percent rate is taxed at an 8-percent rate. Any gain from the sale or exchange of property held more than five years and the holding period for which begins after December 31, 2000, which would otherwise be taxed at a 20-percent rate is taxed at an 18-percent rate.

House Bill

The House bill reduces the 10- and 20 percent rates on the adjusted net capital gain to five and 15 percent, respectively. These lower rates apply to both the regular tax and the alternative minimum tax. The lower rates apply to assets held more than one year.

Effective date.–The provision applies to taxable years ending on or after May 6, 2003,and beginning before January 1, 2013. For taxable years that include May 6, 2003, the lower rates apply to amounts properly taken into account for the portion of the year on or after that date. This generally has the effect of applying the lower rates to capital assets sold or exchanged (and installment payments received) on or after May 6, 2003. In the case of gain and loss taken into account by a pass-through entity, the date taken into account by the entity is the appropriate date for applying this rule.

Senate Amendment

No provision.

Conference Agreement

The conference agreement follows the House bill, except that the 5-percent tax rate is reduced to zero percent for taxable years beginning after December 31, 2007.

Effective date.–The effective date is the same as the House bill, except that the provision does not apply to taxable years beginning after December 31, 2008.

B. Treatment of Dividend Income of Individuals (sec. 302 of the House bill, sec. 201 of the Senate amendment, and sec. 1(h) of the Code)

Present Law

Under present law, dividends received by an individual are included in gross income and taxed as ordinary income at rates up to 38.6 percent.[34]

The rate of tax on the net capital gain of an individual generally is 20 percent (10 percent[35] with respect to income which would otherwise be taxed at the 10- or 15-percent rate).[36] Net capital gain means net gain from the sale or exchange of capital assets held for more than one year in excess of net loss from the sale or exchange of capital assets held not more than one year.

House Bill

Under the House bill, dividends received by an individual shareholder from domestic corporations are taxed at the same rates that apply to net capital gain. This treatment applies for purposes of both the regular tax and the alternative minimum tax. Thus, under the provision, dividends will be taxed at rates of five and 15 percent.[37]

If a shareholder does not hold a share of stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c)),[38] dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

If an individual receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the reduced rates with respect to any share of stock, any loss on the sale of the stock is treated as a long-term capital loss to the extent of the dividend.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

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[34] Section 105 of the bill reduces the maximum rate to 35 percent.

[35] An eight percent rate applies to property held more than five years.

[36] Section 301 of the bill reduces the capital gain rates to five percent (zero percent for taxable years beginning after 2007) and 15 percent, respectively.

[37] Payments in lieu of dividends are not eligible for the exclusion. *See* sections 6042(a) and 6045(d) relating to statements required to be furnished by brokers regarding these payments.

[38] In the case of preferred stock, the periods are doubled.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company ("RIC") or real estate investment trust ("REIT"), for any taxable year that the aggregate qualifying dividends received by the RIC or REIT are less than 95 percent of its gross income (as specially computed), may not exceed the amount of the aggregate qualifying dividends received by the company or trust.

The reduced rates do not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; or deductible dividends paid on employer securities.

The tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is reduced to 15 percent.

Amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of applying the reduced rates.

The collapsible corporation rules (sec. 341) are repealed.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002, and beginning before January 1, 2013.

Senate Amendment

Under the Senate amendment, an individual may exclude from gross income dividends received with respect to stock of a domestic corporation, and stock of a foreign corporation that is regularly tradable on an established securities market.

For taxable years beginning in 2003, 50 percent of the dividend may be excluded from income. For taxable years beginning after 2006, the exclusion no longer applies.

If a shareholder does not hold a share of stock for more than 45 days during the 90-day period beginning 45 days before the ex-dividend date (as measured under section 246(c)),[39] dividends received on the stock are not eligible for the exclusion. Also, the exclusion is not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

If an individual receives an extraordinary dividend (within the meaning of section 1059(c)) eligible for the exclusion with respect to any share of stock, the basis of the share is reduced by the amount of the dividend excludable from income.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the exclusion.

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[39] In the case of preferred stock, the periods are doubled.

The amount of dividends qualifying for the exclusion that may be paid by a RIC or REIT, for any taxable year that the aggregate qualifying dividends received by the company or trust are less than 95 percent of its gross income (as specially computed), may not exceed the amount of such aggregate dividends received by the company or trust.

The exclusion does not apply to dividends received from an organization that was exempt from tax under section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under section 591; deductible dividends paid on employer securities; or dividends received from a foreign corporation that was a foreign investment company (a defined in section 1246(b)), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552) in either the taxable year of the distribution or the preceding taxable year.

In the case of a nonresident alien, the exclusion applies only for purposes of determining the taxes imposed pursuant to sections 871(b) and 877.

No foreign tax credit, or deduction with respect to taxes paid, is allowable with respect to dividends excluded under this provision.

Dividends excluded under the proposal are included in modified adjusted gross income for purposes of the provisions of the Code determining the amount of any income inclusion, exclusion, deduction or credit based on the amount of that income.[40] Also in determining eligibility for the earned income credit, any dividends excluded from gross income under this provision are included in disqualified income for purposes of the determining whether the individual has excessive investment income.

The tax rate for the accumulated earnings tax (sec. 531) and the personal holding company tax (sec. 541) is the taxable percent (*i.e.*, 100 percent less the excludable percentage applicable to dividends received in the taxable year) of the highest individual tax rate.

Amounts treated as ordinary income on the disposition of certain preferred stock (sec. 306) are treated as dividends for purposes of the exclusion.

The collapsible corporation rules (sec. 341) are repealed.

Effective date.–The provision is effective for taxable years beginning after December 31, 2002.

Conference Agreement

The conference agreement follows the House bill taxing dividends at the same rates as net capital gain with the following modifications:

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[40] These provisions include sections 86, 135, 137, 219, 221, 222, 408A, 469, 530, and the nonrefundable personal credits.

The 45-day holding period requirement is increased to 60 days during the 120-day period beginning 60 days before the ex-dividend date.

Qualified dividend income includes otherwise qualified dividends received from qualified foreign corporations. The term "qualified foreign corporation" includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory for purposes of this provision, and which includes an exchange of information program. The conferees do not believe that the current income tax treaty between the United States and Barbados is satisfactory for this purpose because that treaty may operate to provide benefits that are intended for the purpose of mitigating or eliminating double taxation to corporations that are not at risk of double taxation. The conferees intend that, until the Treasury Department issues guidance regarding the determination of treaties as satisfactory for this purpose, a foreign corporation will be considered to be a qualified foreign corporation if it is eligible for the benefits of a comprehensive income tax treaty with the United States that includes an exchange of information program other than the current U.S.-Barbados income tax treaty. The conferees further intend that a company will be eligible for benefits of a comprehensive income tax treaty within the meaning of this provision if it would qualify for the benefits of the treaty with respect to substantially all of its income in the taxable year in which the dividend is paid.

In addition, a foreign corporation is treated as a qualified foreign corporation with respect to any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.[41]

Dividends received from a foreign corporation that was a foreign investment company (a defined in section 1246(b)), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552) in either the taxable year of the distribution or the preceding taxable year are not qualified dividends.

Special rules apply in determining a taxpayer's foreign tax credit limitation under section 904 in the case of qualified dividend income. For these purposes, rules similar to the rules of section 904(b)(2)(B) concerning adjustments to the foreign tax credit limitation to reflect any capital gain rate differential will apply to any qualified dividend income. Additionally, it is anticipated that regulations promulgated under this provision will coordinate the operation of the rules applicable to qualified dividend income and capital gain.

In the case of a REIT, an amount equal to the excess of the income subject to the taxes imposed by section 857(b)(1) and the regulations prescribed under section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year is treated as qualified dividend income.

In the case of brokers and dealers who engage in securities lending transactions, short sales, or other similar transactions on behalf of their customers in the normal course of their trade

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[41] For this purpose, a share shall be treated as so traded if an American Depository Receipt (ADR) backed by such share is so traded.

or business, the conferees intend that the IRS will exercise its authority under section 6724(a) to waive penalties where dealers and brokers attempt in good faith to comply with the information reporting requirements under sections 6042 and 6045, but are unable to reasonably comply because of the period necessary to conform their information reporting systems to the retroactive rate reductions on qualified dividends provided by the conference agreement. In addition, the conferees expect that individual taxpayers who receive payments in lieu of dividends from these transactions may treat the payments as dividend income to the extent that the payments are reported to them as dividend income on their Forms 1099-DIV received for calendar year 2003, unless they know or have reason to know that the payments are in fact payments in lieu of dividends rather than actual dividends. The conferees expect that the Treasury Department will issue guidance as rapidly as possible on information reporting with respect to payments in lieu of dividends made to individuals.

The conference agreement provides that the amendment to section 306 treating certain ordinary income as a dividend for purposes of the rate computation under section 1(h) may also apply to such other provisions as the Secretary may provide, including provisions at the corporate level.

Effective date.–The conference agreement applies to taxable years beginning after December 31, 2002, and beginning before January 1, 2009.

IV. CORPORATE ESTIMATED TAXES

A. Modification to Corporate Estimated Tax Requirements (sec. 401 of the House bill)

Present Law

In general, corporations are required to make quarterly estimated tax payments of their income tax liability (section 6655). For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

House Bill

With respect to corporate estimated tax payments due on September 15, 2003, 52 percent is required to be paid by October 1, 2003.

Effective date.–The provision is effective on the date of enactment.

Senate Amendment

No provision.

Conference Agreement

With respect to corporate estimated tax payments due on September 15, 2003, 25 percent is required to be paid by October 1, 2003.

Effective date.–The provision is effective on the date of enactment.

V. REVENUE PROVISIONS

A. Provisions Designed to Curtail Tax Shelters

1. Clarification of the economic substance doctrine (sec. 301 of the Senate amendment and sec. 7701 of the Code)

<u>**Present Law**</u>

<u>**In general**</u>

The Code provides specific rules regarding the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss and deduction. These rules are designed to provide for the computation of taxable income in a manner that provides for a degree of specificity to both taxpayers and the government. Taxpayers generally may plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

In addition to the statutory provisions, courts have developed several doctrines that can be applied to deny the tax benefits of tax motivated transactions, notwithstanding that the transaction may satisfy the literal requirements of a specific tax provision. The common-law doctrines are not entirely distinguishable, and their application to a given set of facts is often blurred by the courts and the IRS. Although these doctrines serve an important role in the administration of the tax system, invocation of these doctrines can be seen as at odds with an objective, "rule-based" system of taxation. Nonetheless, courts have applied the doctrines to deny tax benefits arising from certain transactions.[42]

A common-law doctrine applied with increasing frequency is the "economic substance" doctrine. In general, this doctrine denies tax benefits arising from transactions that do not result in a meaningful change to the taxpayer's economic position other than a purported reduction in federal income tax.[43]

<u>Economic substance doctrine</u>

Courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks economic substance independent of tax considerations -- notwithstanding that the purported activity actually occurred. The tax court has described the doctrine as follows:

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[42] *See, e.g., ACM Partnership v. Commissioner*, 157 F.3d 231 (3d Cir. 1998), *aff'g* 73 T.C.M. (CCH) 2189 (1997), *cert. denied* 526 U.S. 1017 (1999).

[43] Closely related doctrines also applied by the courts (sometimes interchangeable with the economic substance doctrine) include the "sham transaction doctrine" and the "business purpose doctrine". *See, e.g., Knetsch v. United States*, 364 U.S. 361 (1960) (denying interest deductions on a "sham transaction" whose only purpose was to create the deductions).

> The tax law . . . requires that the intended transactions have economic substance separate and distinct from economic benefit achieved solely by tax reduction. The doctrine of economic substance becomes applicable, and a judicial remedy is warranted, where a taxpayer seeks to claim tax benefits, unintended by Congress, by means of transactions that serve no economic purpose other than tax savings.[44]

Business purpose doctrine

Another common law doctrine that overlays and is often considered together with (if not part and parcel of) the economic substance doctrine is the business purpose doctrine. The business purpose test is a subjective inquiry into the motives of the taxpayer -- that is, whether the taxpayer intended the transaction to serve some useful non-tax purpose. In making this determination, some courts have bifurcated a transaction in which independent activities with non-tax objectives have been combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.[45]

Application by the courts

Elements of the doctrine

There is a lack of uniformity regarding the proper application of the economic substance doctrine. Some courts apply a conjunctive test that requires a taxpayer to establish the presence of both economic substance (i.e., the objective component) and business purpose (i.e., the subjective component) in order for the transaction to sustain court scrutiny.[46] A narrower approach used by some courts is to invoke the economic substance doctrine only after a determination that the transaction lacks both a business purpose and economic substance (i.e., the existence of either a business purpose or economic substance would be sufficient to respect the transaction).[47] A third approach regards economic substance and business purpose as "simply

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[44] *ACM Partnership v. Commissioner*, 73 T.C.M. at 2215.

[45] *ACM Partnership v. Commissioner*, 157 F.3d at 256 n.48.

[46] *See, e.g., Pasternak v. Commissioner*, 990 F.2d 893, 898 (6th Cir. 1993) ("The threshold question is whether the transaction has economic substance. If the answer is yes, the question becomes whether the taxpayer was motivated by profit to participate in the transaction.")

[47] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir. 1985) ("To treat a transaction as a sham, the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and, second, that the transaction has no economic substance because no reasonable possibility of a profit exists."); *IES Industries v. United States,* 253 F.3d 350, 358 (8th Cir. 2001) ("In determining whether a transaction is a sham for tax purposes [under the Eighth Circuit test], a transaction will be characterized as a sham if it is not motivated by any economic purpose out of tax considerations (the business purpose test), and if it is without economic substance because no real potential for profit exists" (the economic substance test).") As noted earlier, the economic substance doctrine and the sham transaction doctrine are similar and sometimes are applied interchangeably. For a

more precise factors to consider" in determining whether a transaction has any practical economic effects other than the creation of tax benefits.[48]

Profit potential

There also is a lack of uniformity regarding the necessity and level of profit potential necessary to establish economic substance. Since the time of *Gregory*, several courts have denied tax benefits on the grounds that the subject transactions lacked profit potential.[49] In addition, some courts have applied the economic substance doctrine to disallow tax benefits in transactions in which a taxpayer was exposed to risk and the transaction had a profit potential, but the court concluded that the economic risks and profit potential were insignificant when compared to the tax benefits.[50] Under this analysis, the taxpayer's profit potential must be more than nominal. Conversely, other courts view the application of the economic substance doctrine as requiring an objective determination of whether a "reasonable possibility of profit" from the transaction existed apart from the tax benefits.[51] In these cases, in assessing whether a

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more detailed discussion of the sham transaction doctrine, *see, e.g.*, Joint Committee on Taxation, *Study of Present-Law Penalty and Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (including Provisions Relating to Corporate Tax Shelters)* (JCS-3-99) at 182.

[48] *See, e.g., ACM Partnership v. Commissioner,* 157 F.3d at 247; *James v. Commissioner,* 899 F.2d 905, 908 (10th Cir. 1995); *Sacks v. Commissioner,* 69 F.3d 982, 985 (9th Cir. 1995) ("Instead, the consideration of business purpose and economic substance are simply more precise factors to consider . . ..We have repeatedly and carefully noted that this formulation cannot be used as a 'rigid two-step analysis'.").

[49] *See, e.g., Knetsch*, 364 U.S. at 361; *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966) (holding that an unprofitable, leveraged acquisition of Treasury bills, and accompanying prepaid interest deduction, lacked economic substance); *Ginsburg v. Commissioner*, 35 T.C.M. (CCH) 860 (1976) (holding that a leveraged cattle-breeding program lacked economic substance).

[50] *See, e.g., Goldstein v. Commissioner,* 364 F.2d at 739-40 (disallowing deduction even though taxpayer had a possibility of small gain or loss by owning Treasury bills); *Sheldon v. Commissioner*, 94 T.C. 738, 768 (1990) (stating, "potential for gain . . . is infinitesimally nominal and vastly insignificant when considered in comparison with the claimed deductions").

[51] *See, e.g., Rice's Toyota World v. Commissioner*, 752 F.2d at 94 (the economic substance inquiry requires an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits); *Compaq Computer Corp. v. Commissioner,* 277 F.3d at 781 (applied the same test, *citing Rice's Toyota World*); *IES Industries v. United States*, 253 F.3d at 354 (the application of the objective economic substance test involves determining whether there was a "reasonable possibility of profit . . . apart from tax benefits.").

reasonable possibility of profit exists, it is sufficient if there is a nominal amount of pre-tax profit as measured against expected net tax benefits.

House Bill

No provision.

Senate Amendment

In general

The Senate amendment clarifies and enhances the application of the economic substance doctrine. The Senate amendment provides that a transaction has economic substance (and thus satisfies the economic substance doctrine) only if the taxpayer establishes that (1) the transaction changes in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and (2) the taxpayer has a substantial non-tax purpose for entering into such transaction and the transaction is a reasonable means of accomplishing such purpose.[52]

The Senate amendment does not change current law standards used by courts in determining when to utilize an economic substance analysis. Also, the Senate amendment does not alter the court's ability to aggregate or disaggregate a transaction when applying the doctrine. The Senate amendment provides a uniform definition of economic substance, but does not alter court flexibility in other respects.

Conjunctive analysis

The Senate amendment clarifies that the economic substance doctrine involves a conjunctive analysis -- there must be an objective inquiry regarding the effects of the transaction on the taxpayer's economic position, as well as a subjective inquiry regarding the taxpayer's motives for engaging in the transaction. Under the Senate amendment, a transaction must satisfy both tests -- i.e., it must change in a meaningful way (apart from Federal income tax consequences) the taxpayer's economic position, and the taxpayer must have a substantial non-tax purpose for entering into such transaction (and the transaction is a reasonable means of accomplishing such purpose) -- in order to satisfy the economic substance doctrine. This clarification eliminates the disparity that exists among the circuits regarding the application of the doctrine, and modifies its application in those circuits in which either a change in economic position or a non-tax business purpose (without having both) is sufficient to satisfy the economic substance doctrine.

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[52] If the tax benefits are clearly contemplated and expected by the language and purpose of the relevant authority, it is not intended that such tax benefits be disallowed if the only reason for such disallowance is that the transaction fails the economic substance doctrine as defined in this provision.

Non-tax business purpose

The Senate amendment provides that a taxpayer's non-tax purpose for entering into a transaction (the second prong in the analysis) must be "substantial," and that the transaction must be "a reasonable means" of accomplishing such purpose. Under this formulation, the non-tax purpose for the transaction must bear a reasonable relationship to the taxpayer's normal business operations or investment activities.[53]

In determining whether a taxpayer has a substantial non-tax business purpose, an objective of achieving a favorable accounting treatment for financial reporting purposes will not be treated as having a substantial non-tax purpose if the origin of such financial accounting benefit is a reduction of income tax. Furthermore, a transaction that is expected to increase financial accounting income as a result of generating tax deductions or losses without a corresponding financial accounting charge (i.e., a permanent book-tax difference)[54] should not be considered to have a substantial non-tax purpose unless a substantial non-tax purpose exists apart from the financial accounting benefits.[55]

By requiring that a transaction be a "reasonable means" of accomplishing its non-tax purpose, the Senate amendment broadens the ability of the courts to bifurcate a transaction in which independent activities with non-tax objectives are combined with an unrelated item having only tax-avoidance objectives in order to disallow the tax benefits of the overall transaction.

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[53] *See,* Martin McMahon Jr., *Economic Substance, Purposive Activity, and Corporate Tax Shelters,* 94 Tax Notes 1017, 1023 (Feb. 25, 2002) (advocates "confining the most rigorous application of business purpose, economic substance, and purposive activity tests to transactions outside the ordinary course of the taxpayer's business -- those transactions that do not appear to contribute to any business activity or objective that the taxpayer may have had apart from tax planning but are merely loss generators."); Mark P. Gergen, *The Common Knowledge of Tax Abuse,* 54 SMU L. Rev. 131, 140 (Winter 2001) ("The message is that you can pick up tax gold if you find it in the street while going about your business, but you cannot go hunting for it.").

[54] This includes tax deductions or losses that are anticipated to be recognized in a period subsequent to the period the financial accounting benefit is recognized. For example, FAS 109 in some cases permits the recognition of financial accounting benefits prior to the period in which the tax benefits are recognized for income tax purposes.

[55] Claiming that a financial accounting benefit constitutes a substantial non-tax purpose fails to consider the origin of the accounting benefit (i.e., reduction of taxes) and significantly diminishes the purpose for having a substantial non-tax purpose requirement. *See, e.g., American Electric Power, Inc. v. U.S.,* 136 F. Supp. 2d 762, 791-92 (S.D. Ohio, 2001), *aff'd* by 2003 Fed. App. para. 0125 (CCH) (6th Cir. 2003) ("AEP's intended use of the cash flows generated by the [corporate-owned life insurance] plan is irrelevant to the subjective prong of the economic substance analysis. If a legitimate business purpose for the use of the tax savings 'were sufficient to breathe substance into a transaction whose only purpose was to reduce taxes, [then] every sham tax-shelter device might succeed,'" *citing Winn-Dixie v. Commissioner,* 113 T.C. 254, 287 (1999)).

Profit potential

Under the Senate amendment, a taxpayer may rely on factors other than profit potential to demonstrate that a transaction results in a meaningful change in the taxpayer's economic position; the Senate amendment merely sets forth a minimum threshold of profit potential if that test is relied on to demonstrate a meaningful change in economic position. If a taxpayer relies on a profit potential, however, the present value of the reasonably expected pre-tax profit must be substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected.[56] Moreover, the profit potential must exceed a risk-free rate of return. In addition, in determining pre-tax profit, fees and other transaction expenses and foreign taxes are treated as expenses.

A lessor of tangible property subject to a qualified lease shall be considered to have satisfied the profit test with respect to the leased property. For this purpose, a 'qualified lease" is a lease that satisfies the factors for advance ruling purposes as provided by the Treasury Department.[57]In applying the profit test to the lessor of tangible property, certain deductions and other applicable tax credits (such as the rehabilitation tax credit and the low income housing tax credit) are not taken into account in measuring tax benefits. Thus, a traditional leveraged lease is not affected by the Senate amendment to the extent it meets the present law standards.

Transactions with tax-indifferent parties

The Senate amendment also provides special rules for transactions with tax-indifferent parties. For this purpose, a tax-indifferent party means any person or entity not subject to Federal income tax, or any person to whom an item would have no substantial impact on its income tax liability. Under these rules, the form of a financing transaction will not be respected if the present value of the tax deductions to be claimed is substantially in excess of the present value of the anticipated economic returns to the lender. Also, the form of a transaction with a tax-indifferent party will not be respected if it results in an allocation of income or gain to the tax-indifferent party in excess of the tax-indifferent party's economic gain or income or if the transaction results in the shifting of basis on account of overstating the income or gain of the tax-indifferent party.

Other rules

The Secretary may prescribe regulations which provide (1) exemptions from the application of the Senate amendment, and (2) other rules as may be necessary or appropriate to carry out the purposes of the Senate amendment.

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[56] Thus, a "reasonable possibility of profit" will not be sufficient to establish that a transaction has economic substance.

[57] See Rev. Proc. 2001-28, 2001-19 I.R.B. 1156 which provides guidelines that must be present for a lease to be eligible for advance ruling purposes. It is intended that a lease that satisfies Treasury Department guidelines for advance ruling purposes would be treated as a qualified lease.

No inference is intended as to the proper application of the economic substance doctrine under present law. In addition, except with respect to the economic substance doctrine, the Senate amendment shall not be construed as altering or supplanting any other common law doctrine (including the sham transaction doctrine), and the Senate amendment shall be construed as being additive to any such other doctrine.

Effective date

The provision applies to transactions entered into on or after May 8, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

2. Penalty for failure to disclose reportable transactions (sec. 302 of the Senate amendment and sec. 6707A of the Code)

Present Law

Regulations under section 6011 require a taxpayer to disclose with its tax return certain information with respect to each "reportable transaction" in which the taxpayer participates.[58]

There are six categories of reportable transactions. The first category is any transaction that is the same as (or substantially similar to)[59] a transaction that is specified by the Treasury Department as a tax avoidance transaction whose tax benefits are subject to disallowance under present law (referred to as a "listed transaction").[60]

The second category is any transaction that is offered under conditions of confidentiality. In general, if a taxpayer's disclosure of the structure or tax aspects of the transaction is limited in any way by an express or implied understanding or agreement with or for the benefit of any person who makes or provides a statement, oral or written, as to the potential tax consequences

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[58] On February 27, 2003, the Treasury Department and the IRS released final regulations regarding the disclosure of reportable transactions. In general, the regulations are effective for transactions entered into on or after February 28, 2003.

The discussion of present law refers to the new regulations. The rules that apply with respect to transactions entered into on or before February 28, 2003, are contained in Treas. Reg. sec. 1.6011-4T in effect on the date the transaction was entered into.

[59] The regulations clarify that the term "substantially similar" includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Further, the term must be broadly construed in favor of disclosure. Treas. Reg. sec. 1-6011-4(c)(4).

[60] Treas. Reg. sec. 1.6011-4(b)(2).

that may result from the transaction, it is considered offered under conditions of confidentiality (whether or not the understanding is legally binding).[61]

The third category of reportable transactions is any transaction for which (1) the taxpayer has the right to a full or partial refund of fees if the intended tax consequences from the transaction are not sustained or, (2) the fees are contingent on the intended tax consequences from the transaction being sustained.[62]

The fourth category of reportable transactions relates to any transaction resulting in a taxpayer claiming a loss (under section 165) of at least (1) $10 million in any single year or $20 million in any combination of years by a corporate taxpayer or a partnership with only corporate partners; (2) $2 million in any single year or $4 million in any combination of years by all other partnerships, S corporations, trusts, and individuals; or (3) $50,000 in any single year for individuals or trusts if the loss arises with respect to foreign currency translation losses.[63]

The fifth category of reportable transactions refers to any transaction done by certain taxpayers[64] in which the tax treatment of the transaction differs (or is expected to differ) by more than $10 million from its treatment for book purposes (using generally accepted accounting principles) in any year.[65]

The final category of reportable transactions is any transaction that results in a tax credit exceeding $250,000 (including a foreign tax credit) if the taxpayer holds the underlying asset for less than 45 days.[66]

Under present law, there is no specific penalty for failing to disclose a reportable transaction; however, such a failure may jeopardize a taxpayer's ability to claim that any income tax understatement attributable to such undisclosed transaction is due to reasonable cause, and that the taxpayer acted in good faith.[67]

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[61] Treas. Reg. sec. 1.6011-4(b)(3).

[62] Treas. Reg. sec. 1.6011-4(b)(4).

[63] Treas. Reg. sec. 1.6011-4(b)(5). IRS Rev. Proc. 2003-24, 2003-11 I.R.B. 599, exempts certain types of losses from this reportable transaction category.

[64] The significant book-tax category applies only to taxpayers that are reporting companies under the Securities Exchange Act of 1934 or business entities that have $250 million or more in gross assets.

[65] Treas. Reg. sec. 1.6011-4(b)(6). IRS Rev. Proc. 2003-25, 2003-11 I.R.B. 601, exempts certain types of transactions from this reportable transaction category.

[66] Treas. Reg. sec. 1.6011-4(b)(7).

[67] Section 6664(c) provides that a taxpayer can avoid the imposition of a section 6662 accuracy-related penalty in cases where the taxpayer can demonstrate that there was reasonable

House Bill

No provision.

Senate Amendment

In general

The Senate amendment creates a new penalty for any person who fails to include with any return or statement any required information with respect to a reportable transaction. The new penalty applies without regard to whether the transaction ultimately results in an understatement of tax, and applies in addition to any accuracy-related penalty that may be imposed.

Transactions to be disclosed

The Senate amendment does not define the terms "listed transaction"[68] or "reportable transaction," nor does the Senate amendment explain the type of information that must be disclosed in order to avoid the imposition of a penalty. Rather, the Senate amendment authorizes the Treasury Department to define a "listed transaction" and a "reportable transaction" under section 6011.

Penalty rate

The penalty for failing to disclose a reportable transaction is $50,000. The amount is increased to $100,000 if the failure is with respect to a listed transaction. For large entities and high net worth individuals, the penalty amount is doubled (i.e., $100,000 for a reportable transaction and $200,000 for a listed transaction). The penalty cannot be waived with respect to a listed transaction. As to reportable transactions, the penalty can be rescinded (or abated) only if: (1) the taxpayer on whom the penalty is imposed has a history of complying with the Federal tax laws, (2) it is shown that the violation is due to an unintentional mistake of fact, (3) imposing the penalty would be against equity and good conscience, and (4) rescinding the penalty would promote compliance with the tax laws and effective tax administration. The authority to rescind the penalty can only be exercised by the IRS Commissioner personally or the head of the Office

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cause for the underpayment and that the taxpayer acted in good faith. On December 31, 2002, the Treasury Department and IRS issued proposed regulations under sections 6662 and 6664 (REG-126016-01) that limit the defenses available to the imposition of an accuracy-related penalty in connection with a reportable transaction when the transaction is not disclosed.

[68] The provision states that, except as provided in regulations, a listed transaction means a reportable transaction, which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011. For this purpose, it is expected that the definition of "substantially similar" will be the definition used in Treas. Reg. sec. 1.6011-4(c)(4). However, the Secretary may modify this definition (as well as the definitions of "listed transaction" and "reportable transactions") as appropriate.

of Tax Shelter Analysis. Thus, the penalty cannot be rescinded by a revenue agent, an Appeals officer, or any other IRS personnel. The decision to rescind a penalty must be accompanied by a record describing the facts and reasons for the action and the amount rescinded. There will be no taxpayer right to appeal a refusal to rescind a penalty. The IRS also is required to submit an annual report to Congress summarizing the application of the disclosure penalties and providing a description of each penalty rescinded under this provision and the reasons for the rescission.

A "large entity" is defined as any entity with gross receipts in excess of $10 million in the year of the transaction or in the preceding year. A "high net worth individual" is defined as any individual whose net worth exceeds $2 million, based on the fair market value of the individual's assets and liabilities immediately before entering into the transaction.

A public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction, a non-disclosed reportable avoidance transaction,[69] or a transaction that lacks economic substance) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission for such period as the Secretary shall specify. The provision applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and treats any failure to disclose a transaction in such reports as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the Securities and Exchange Commission once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Effective date

The provision is effective for returns and statements the due date for which is after the date of enactment.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

3. Modifications to the accuracy-related penalties for listed transactions and reportable transactions having a significant tax avoidance purpose (sec. 303 of the Senate amendment and sec. 6662A of the Code)

Present Law

The accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may

[69] A reportable avoidance transaction is a reportable transaction with a significant tax avoidance purpose.

be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[70] The amount of any understatement generally is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.[71]

Special rules apply with respect to tax shelters.[72] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The understatement penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[73] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[74]

House Bill

No provision.

Senate Amendment

In general

The Senate amendment modifies the present-law accuracy related penalty by replacing the rules applicable to tax shelters with a new accuracy-related penalty that applies to listed transactions and reportable transactions with a significant tax avoidance purpose (hereinafter referred to as a "reportable avoidance transaction").[75] The penalty rate and defenses available to avoid the penalty vary depending on whether the transaction was adequately disclosed.

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[70] Sec. 6662.

[71] Sec. 6662(d)(2)(B).

[72] Sec. 6662(d)(2)(C).

[73] Sec. 6664(c).

[74] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

[75] The terms "reportable transaction" and "listed transaction" have the same meanings as used for purposes of the penalty for failing to disclose reportable transactions.

Disclosed transactions

In general, a 20-percent accuracy-related penalty is imposed on any understatement attributable to an adequately disclosed listed transaction or reportable avoidance transaction. The only exception to the penalty is if the taxpayer satisfies a more stringent reasonable cause and good faith exception (hereinafter referred to as the "strengthened reasonable cause exception"), which is described below. The strengthened reasonable cause exception is available only if the relevant facts affecting the tax treatment are adequately disclosed, there is or was substantial authority for the claimed tax treatment, and the taxpayer reasonably believed that the claimed tax treatment was more likely than not the proper treatment.

Undisclosed transactions

If the taxpayer does not adequately disclose the transaction, the strengthened reasonable cause exception is not available (i.e., a strict-liability penalty applies), and the taxpayer is subject to an increased penalty rate equal to 30 percent of the understatement.

In addition, a public entity that is required to pay the 30 percent penalty must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once the 30 percent penalty has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this provision and the reasons for the compromise.

Determination of the understatement amount

The penalty is applied to the amount of any understatement attributable to the listed or reportable avoidance transaction without regard to other items on the tax return. For purposes of the Senate amendment, the amount of the understatement is determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return) [76], and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item.

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[76] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses which would (without regard to section 1211) be allowed for such year, shall be treated as an increase in taxable income.

Except as provided in regulations, a taxpayer's treatment of an item shall not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of when the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

Strengthened reasonable cause exception

A penalty is not imposed under the Senate amendment with respect to any portion of an understatement if it shown that there was reasonable cause for such portion and the taxpayer acted in good faith. Such a showing requires (1) adequate disclosure of the facts affecting the transaction in accordance with the regulations under section 6011,[77] (2) that there is or was substantial authority for such treatment, and (3) that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment. For this purpose, a taxpayer will be treated as having a reasonable belief with respect to the tax treatment of an item only if such belief (1) is based on the facts and law that exist at the time the tax return (that includes the item) is filed, and (2) relates solely to the taxpayer's chances of success on the merits and does not take into account the possibility that (a) a return will not be audited, (b) the treatment will not be raised on audit, or (c) the treatment will be resolved through settlement if raised.

A taxpayer may (but is not required to) rely on an opinion of a tax advisor in establishing its reasonable belief with respect to the tax treatment of the item. However, a taxpayer may not rely on an opinion of a tax advisor for this purpose if the opinion (1) is provided by a "disqualified tax advisor," or (2) is a "disqualified opinion."

Disqualified tax advisor

A disqualified tax advisor is any advisor who (1) is a material advisor[78] and who participates in the organization, management, promotion or sale of the transaction or is related (within the meaning of section 267 or 707) to any person who so participates, (2) is compensated directly or indirectly[79] by a material advisor with respect to the transaction, (3) has a fee arrangement with respect to the transaction that is contingent on all or part of the intended tax

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[77] *See* the previous discussion regarding the penalty for failing to disclose a reportable transaction.

[78] The term "material advisor" (defined below in connection with the new information filing requirements for material advisors) means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing, or carrying out any reportable transaction, and who derives gross income in excess of $50,000 in the case of a reportable transaction substantially all of the tax benefits from which are provided to natural persons ($250,000 in any other case).

[79] This situation could arise, for example, when an advisor has an arrangement or understanding (oral or written) with an organizer, manager, or promoter of a reportable transaction that such party will recommend or refer potential participants to the advisor for an opinion regarding the tax treatment of the transaction.

benefits from the transaction being sustained, or (4) as determined under regulations prescribed by the Secretary, has a continuing financial interest with respect to the transaction.

A material advisor is considered as participating in the "organization" of a transaction if the advisor performs acts relating to the development of the transaction. This may include, for example, preparing documents (1) establishing a structure used in connection with the transaction (such as a partnership agreement), (2) describing the transaction (such as an offering memorandum or other statement describing the transaction), or (3) relating to the registration of the transaction with any federal, state or local government body.[80] Participation in the "management" of a transaction means involvement in the decision-making process regarding any business activity with respect to the transaction. Participation in the "promotion or sale" of a transaction means involvement in the marketing or solicitation of the transaction to others. Thus, an advisor who provides information about the transaction to a potential participant is involved in the promotion or sale of a transaction, as is any advisor who recommends the transaction to a potential participant.

Disqualified opinion

An opinion may not be relied upon if the opinion (1) is based on unreasonable factual or legal assumptions (including assumptions as to future events), (2) unreasonably relies upon representations, statements, finding or agreements of the taxpayer or any other person, (3) does not identify and consider all relevant facts, or (4) fails to meet any other requirement prescribed by the Secretary.

Coordination with other penalties

Any understatement upon which a penalty is imposed under this provision is not subject to the accuracy-related penalty under section 6662. However, such understatement is included for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1).

The penalty imposed under this provision shall not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective date

The provision is effective for taxable years ending after the date of enactment.

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[80] An advisor should not be treated as participating in the organization of a transaction if the advisor's only involvement with respect to the organization of the transaction is the rendering of an opinion regarding the tax consequences of such transaction. However, such an advisor may be a "disqualified tax advisor" with respect to the transaction if the advisor participates in the management, promotion or sale of the transaction (or if the advisor is compensated by a material advisor, has a fee arrangement that is contingent on the tax benefits of the transaction, or as determined by the Secretary, has a continuing financial interest with respect to the transaction).

Conference Agreement

The conference agreement does not include the Senate amendment provision.

4. Penalty for understatements from transactions lacking economic substance (sec. 304 of the Senate amendment and sec. 6662B of the Code)

Present Law

An accuracy-related penalty applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, or (5) any substantial estate or gift tax valuation understatement. If the correct income tax liability exceeds that reported by the taxpayer by the greater of 10 percent of the correct tax or $5,000 ($10,000 in the case of corporations), then a substantial understatement exists and a penalty may be imposed equal to 20 percent of the underpayment of tax attributable to the understatement.[81] The amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

Special rules apply with respect to tax shelters.[82] For understatements by non-corporate taxpayers attributable to tax shelters, the penalty may be avoided only if the taxpayer establishes that, in addition to having substantial authority for the position, the taxpayer reasonably believed that the treatment claimed was more likely than not the proper treatment of the item. This reduction in the penalty is unavailable to corporate tax shelters.

The penalty generally is abated (even with respect to tax shelters) in cases in which the taxpayer can demonstrate that there was "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[83] The relevant regulations provide that reasonable cause exists where the taxpayer "reasonably relies in good faith on an opinion based on a professional tax advisor's analysis of the pertinent facts and authorities [that] . . . unambiguously concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged" by the IRS.[84]

House Bill

No provision.

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[81] Sec. 6662.

[82] Sec. 6662(d)(2)(C).

[83] Sec. 6664(c).

[84] Treas. Reg. sec. 1.6662-4(g)(4)(i)(B); Treas. Reg. sec. 1.6664-4(c).

Senate Amendment

The Senate amendment imposes a penalty for an understatement attributable to any transaction that lacks economic substance (referred to in the statute as a "non-economic substance transaction understatement").[85] The penalty rate is 40 percent (reduced to 20 percent if the taxpayer adequately discloses the relevant facts in accordance with regulations prescribed under section 6011). No exceptions (including the reasonable cause or rescission rules) to the penalty would be available under the Senate amendment (i.e., the penalty is a strict-liability penalty).

A "non-economic substance transaction" means any transaction if (1) the transaction lacks economic substance (as defined in the earlier Senate amendment provision regarding the economic substance doctrine),[86] (2) the transaction was not respected under the rules relating to transactions with tax-indifferent parties (as described in the earlier Senate amendment provision regarding the economic substance doctrine),[87] or (3) any similar rule of law. For this purpose, a similar rule of law would include, for example, an understatement attributable to a transaction that is determined to be a sham transaction.

For purposes of the Senate amendment, the calculation of an "understatement" is made in the same manner as in the separate Senate amendment provision relating to accuracy-related penalties for listed and reportable avoidance transactions (new sec. 6662A). Thus, the amount of the understatement under the Senate amendment would be determined as the sum of (1) the product of the highest corporate or individual tax rate (as appropriate) and the increase in taxable income resulting from the difference between the taxpayer's treatment of the item and the proper treatment of the item (without regard to other items on the tax return),[88] and (2) the amount of any decrease in the aggregate amount of credits which results from a difference between the taxpayer's treatment of an item and the proper tax treatment of such item. In essence, the penalty will apply to the amount of any understatement attributable solely to a non-economic substance transaction.

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[85] Thus, unlike the new accuracy-related penalty under section 6662A (which applies only to listed and reportable avoidance transactions), the new penalty under this provision applies to any transaction that lacks economic substance.

[86] The provision provides that a transaction has economic substance only if: (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the transaction has a substantial non-tax purpose for entering into such transaction and is a reasonable means of accomplishing such purpose.

[87] The provision provides that the form of a transaction that involves a tax-indifferent party will not be respected in certain circumstances.

[88] For this purpose, any reduction in the excess of deductions allowed for the taxable year over gross income for such year, and any reduction in the amount of capital losses that would (without regard to section 1211) be allowed for such year, would be treated as an increase in taxable income.

Except as provided in regulations, the taxpayer's treatment of an item will not take into account any amendment or supplement to a return if the amendment or supplement is filed after the earlier of the date the taxpayer is first contacted regarding an examination of the return or such other date as specified by the Secretary.

A public entity that is required to pay a penalty under the Senate amendment (regardless of whether the transaction was disclosed) must disclose the imposition of the penalty in reports to the SEC for such periods as the Secretary shall specify. The disclosure to the SEC applies without regard to whether the taxpayer determines the amount of the penalty to be material to the reports in which the penalty must appear, and any failure to disclose such penalty in the reports is treated as a failure to disclose a listed transaction. A taxpayer must disclose a penalty in reports to the SEC once the taxpayer has exhausted its administrative and judicial remedies with respect to the penalty (or if earlier, when paid).

Once a penalty (regardless of whether the transaction was disclosed) has been included in the Revenue Agent Report, the penalty cannot be compromised for purposes of a settlement without approval of the Commissioner personally or the head of the Office of Tax Shelter Analysis. Furthermore, the IRS is required to submit an annual report to Congress summarizing the application of this penalty and providing a description of each penalty compromised under this provision and the reasons for the compromise.

Any understatement to which a penalty is imposed under the Senate amendment will not be subject to the accuracy-related penalty under section 6662 or under new 6662A (accuracy-related penalties for listed and reportable avoidance transactions). However, an understatement under this provision would be taken into account for purposes of determining whether any understatement (as defined in sec. 6662(d)(2)) is a substantial understatement as defined under section 6662(d)(1). The penalty imposed under this provision will not apply to any portion of an understatement to which a fraud penalty is applied under section 6663.

Effective date.–The provision applies to transactions entered into on or after May 8, 2003.

Conference Agreement

The conference agreement does not include the Senate amendment provision.

5. Modifications to the substantial understatement penalty (sec. 305 of the Senate amendment and sec. 6662of the Code)

Present Law

Definition of substantial understatement

An accuracy-related penalty equal to 20 percent applies to any substantial understatement of tax. A "substantial understatement" exists if the correct income tax liability for a taxable year